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**REPORT FROM THE COMMISSION TO THE COUNCIL AND
THE EUROPEAN PARLIAMENT**

**Report from the Commission to the Council and the European Parliament
on the implementation of macro-financial assistance to third countries in 2006**

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1. INTRODUCTION

This report provides a general overview of the EC macro-financial assistance to third countries including historical background, a summary of the operations in 2006, information regarding the most recent operations in the Western Balkans and in the New Independent States and statistical tables of the different operations carried out since 1990.

The last recent trends of EC macro-financial operations together with the results of the three ex-post evaluations that have been carried out, respectively in 2005 and 2006, are included in this report. The objective of these evaluations is to assess the impact on the relevant aspects of the economic stabilisation process and the implementation of structural reforms in the recipient countries. Progress in this respect also reflects the degree to which the corresponding economic policy conditions attached to the EC macro-financial assistance have been met. In addition, two new ex-post evaluations are being conducted. The final reports should be made available at the end of 2007.

Moreover, as regards the recommendation of the Court of Auditors in their special report of March 2002 on improvement of financial management in the beneficiary countries, the Commission has carried out since 2004, with the assistance of an audit firm, operational assessments of the financial circuits and controls organisation related to macro-financial assistance in every beneficiary country. The conclusions of these assessments are being duly taken into account in the elaboration of the policy conditions attached to the implementation of this assistance.

This report is submitted in accordance with the Council decisions regarding Community macro-financial or exceptional financial assistance to third countries and follows on from the reports presented in previous years. A more detailed report (working document of the Commission services SEC(2007...) providing economic and financial information regarding the beneficiary countries is released in parallel.

2. OVERVIEW

2.1. Background

Macro-financial assistance (MFA) supports the political and economic reform efforts of the beneficiary countries and is implemented in association with support programmes from the IMF and the World Bank. MFA incorporates a set of principles reaffirmed by the Council in its conclusions of 8 October 2002, which underline the exceptional character of this assistance, its complementarity to financing from the International Financial Institutions (IFIs) and its macroeconomic conditionality. In particular, Community MFA has supported efforts by recipient countries to bring about economic reforms and structural changes. In close co-ordination with the IMF and the World Bank, it has promoted policies that are tailored to specific country needs with the overall objective of stabilising the financial situation and establishing market-oriented economies.

2.2. Macro-Financial Assistance in 2006

During the period 2000-2006, seventeen decisions have been approved for a total amount of EUR 960 million. The Balkans countries (The former Yugoslav Republic of Macedonia, Bosnia and Herzegovina, Serbia and Montenegro including Kosovo and Albania) have benefited from thirteen assistance decisions of the Council. This makes the Balkans countries the main beneficiaries of MFA with a total of assistance amounting to a maximum of EUR 783 million out of 960 million.

2.2.1. New decisions

Two decisions have been adopted by the Council in 2006.

On 24th January, the Council decided (2006/40/EC) to provide macro-financial assistance to Georgia of up to EUR 33.5 million in the form of grants.

On 30th November, the Council decided (2006/880/EC) to provide macro-financial assistance to Kosovo¹ of up to EUR 50 million in the form of grants.

Moreover, the Commission adopted on 9 October 2006 a proposal to provide macro-financial assistance to Moldova of up to EUR 45 million (grant only) and presented it to the Council. This proposal was adopted by the Council on 16 April 2007 (2007/259/EC).

2.2.2. Disbursements

Disbursements of Macro-financial assistance amounted to a total of EUR 61 million in 2006 of which EUR 42 million in the form of grants: EUR 13 million for Albania, EUR 7 million for Tajikistan, EUR 22 million for Georgia (two tranches of EUR 11 million).

Assistance disbursed in the form of loans amounted to EUR 10 million to Bosnia and Herzegovina and EUR 9 million to Albania.

¹ As defined in UNSCR 1244/99.

2.3. Synthesis of the most recent operations in the beneficiary countries

2.3.1. *Western Balkans*

A EUR 60 million MFA operation in favour of **Bosnia and Herzegovina** approved by the Council on 5 November 2002 (and amended by the Council on 7 December 2004) came to an end in February 2006, with the disbursement of the EUR 10 million loan component of the last tranche. The grant component had already been released in 2005 upon satisfactory fulfilment of conditionality requirements.

The assistance to Serbia and Montenegro of up to EUR 200 million (EUR 120 million grant and EUR 80 million loan), which the Council of Minister had approved on 5 November 2002 and 25 November 2003, expired on 30 June 2006. Out of this assistance, EUR 155 million (EUR 100 million grant and EUR 55 million loan) had been disbursed in four tranches prior to 2006. The loan element of the fourth tranche of EUR 15 million could not be paid in the first half of 2006 as intended, as the authorities did not complete before the expiry date on 30 June 2006 the legal conditions required for the loan disbursement. In July, after Montenegro became an independent country, the authorities of Montenegro and of Serbia were also formally notified by the Commission of its decision not to disburse the fifth and final tranche of this assistance for an amount of EUR 30 million (EUR 20 million in grant and EUR 10 million in loan) due to the strong improvements of the external financing situation in Serbia and Montenegro in 2006. Hence, EUR 45 million were cancelled.

The EUR 25 million MFA operation in favour of Albania launched in 2004 has also been concluded in 2006. The EUR 3 million grant component of the first tranche was paid in November 2005, and the EUR 9 million loan component of the first tranche was disbursed on 23 March 2006. The second and final EUR 13 million grant tranche of the assistance was disbursed on 31 July 2006, following a favourable assessment by the Commission of Albania's progress in reforming key areas such as public finance management, public administration, financial sector, business environment and private sector development.

In May 2006, the Commission submitted to the Council a proposal of exceptional financial assistance of up to EUR 50 million in the form of grants, to support Kosovo's expected budget financing needs. The Council adopted the decision on 30 November. This assistance is conceived as bridge support pending a comprehensive assessment of needs upon status settlement of Kosovo. Commission staff went on mission to Pristina at the end of the year to review financing needs with the authorities of Kosovo and examine possible conditions to be attached to this assistance.

2.3.2. *New Independent States*

Macro-financial assistance multi-annual programmes were decided in 1997 and 2000 in favour of Armenia, Georgia and Tajikistan. The last disbursement to Tajikistan (a grant of EUR 7 million) was made in October 2006. The last disbursements to Georgia and Armenia had been made in 2004 and 2005. This multi-annual programme is now completed.

The Council adopted, in January 2006, a new macro-financial assistance programme in favour of Georgia for an amount of EUR 33.5 million in grants. This new programme is linked to early repayment by Georgia of the country's debt to the EU.

The payments of the first and second tranche (EUR 11.5 million each) were made in August and December 2006.

The Council had decided in 2002 to grant macro-financial assistance to Ukraine (EUR 110 million in loans). In the absence of working financing arrangement with the IMF, the implementation of the programme has never started. As there is no expiration date in the corresponding Council Decision, this programme can (in principle) be reactivated in the future.

The Commission submitted to the Council, in October 2006, a proposal for a new MFA programme for Moldova in the context of a new PRGF2 arrangement with the IMF. The final Decision was adopted by the Council on 16 April 2007. Under this programme, the Commission should disburse in 2007-2008 a total amount of EUR 45 million in grants. This programme will help Moldova implementing its economic programme and contribute to cover the country's external financing needs linked to external shocks faced by Moldova's economy (primarily, the increase of prices for natural gas imported from Russia and restrictions on Moldova's exports of wine and several agricultural products). The Community macro-financial assistance will complement new financing from the IFIs and bilateral donors and budget support provided by the EU under the Food Security Programme and by the new European Neighbourhood and Partnership Instrument (ENPI).

² Poverty Reduction and Growth Facility.

3. GEOGRAPHICAL DISTRIBUTION AND EVALUATIONS OF MACRO-FINANCIAL ASSISTANCE

3.1. Geographical distribution

The EC MFA is intended to support macroeconomic stabilisation of the beneficiary countries and ease their balance of payments (and budget) difficulties. It plays also a very useful role in promoting structural reform. The highest volumes of MFA operations were decided and disbursed in the years immediately after the changes in the countries of the Central and Eastern Europe.

Over the years, the number of countries to which the Community extended such support expanded, as a growing number of countries neighbouring the EU faced balance of payments difficulties and committed themselves to programmes of economic reform. This led to a change in the geographic balance of assistance from the early years, when most beneficiary countries were countries in Central and Eastern Europe. Hence, since 2000, MFA has been exclusively provided to the Western Balkans (83% of the decisions from 2000 to 2006) and to the NIS countries.

3.2. Evaluations

According to the financial regulation the Commission has implemented an evaluation programme in order to assess the impact of MFA in each of the beneficiary countries. The analyses are carried out by external consultants selected by open call for tenders. At the end of 2006 three ex-post evaluation have been completed in Armenia, Romania and former Yugoslav Republic of Macedonia by two different firms. The main observations are the following:

3.2.1. Armenia

The evaluation concluded that the assistance contributed to the short-term macroeconomic stabilisation, improved the external financial situation and contributed to the alleviation of social hardship in the short-term. On the other hand, MFA was not totally effective for supporting economic and institutional reforms in the short and medium term. As a consequence, the impact of MFA on the financial situation of Armenia appears limited.

3.2.2. Romania

The MFA operation contributed directly to improve the financial sustainability of the country in the medium and long term prospect and supported policies in order to introduce market economy principles. Romania benefited of several assistance programmes in the context of pre-accession policies, hence it is difficult to determine exactly the impact of MFA operations in isolation from the rest of the programmes.

3.2.3. *The former Yugoslav Republic of Macedonia*

MFA operations had a positive effect on the balance of payments of the country and contributed to relax budgetary constraints. They also led to a slightly higher economic growth. The impact of MFA on medium-to-long term external sustainability is positive, however, the analysis indicated that the size of this impact is limited.

In each case the decision of the Commission to release the funds instilled confidence in the economy of these countries and thus contributed to the improvement of their business environment.

3.3. **Improving financial management in beneficiary countries: the operational assessments**

Since 2004 a total of 7 operational assessments were carried out in the countries benefiting from macro-financial assistance (Albania, Armenia, Tajikistan, Serbia-Montenegro, Bosnia-Herzegovina, Georgia and Kosovo). The work programme of each operational assessment was elaborated in accordance with the SIGMA3 methodology, in co-operation with the consulting firm Deloitte. The investigations focus on the one hand on the independence of the Central Banks and the functioning of their accounting departments. On the other hand, they examine the Ministries of Finance (on the budget process, the treasury departments, the internal audit, human resources and IT departments). The functioning of the external audit institutions is also systematically reviewed in order to assess their control methodology.

The most frequent recommendations regard the Ministry of Finance and the necessity to implement single treasury accounts, appropriate accounting systems and written procedures. The capacity of the internal control, in each case, had to be strengthened and special training sessions were recommended. In some cases, macro-economic forecast departments appear insufficient to fulfil their role. The independence of the external audit institutions was not considered as sufficient.

In most cases, the assessments concluded that "The framework for sound financial management is effective". The most serious weaknesses detected during these missions have been addressed in the MoU, with short deadlines to correct the situation. In the case of Bosnia and Herzegovina where the MoU was already signed, prior actions were defined to be taken before further disbursements such as the strengthening of the internal control department within the Ministry of Finance and the adoption of instructions containing minimal requirements regarding the segregation of duties as regards accounting, authorizing and payment functions. Follow-up missions have been undertaken (Albania, Armenia, Tajikistan, Georgia) in order to assess the improvements implemented in the national administrations following the initial recommendations.

Three years after the beginning of these operational assessments and despite some delays in the implementation of the requested modifications, the Commission has noticed real improvements in the public finance management of all these countries,

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Support for Improvement in Governance and Management in Central and Eastern Europe Countries.

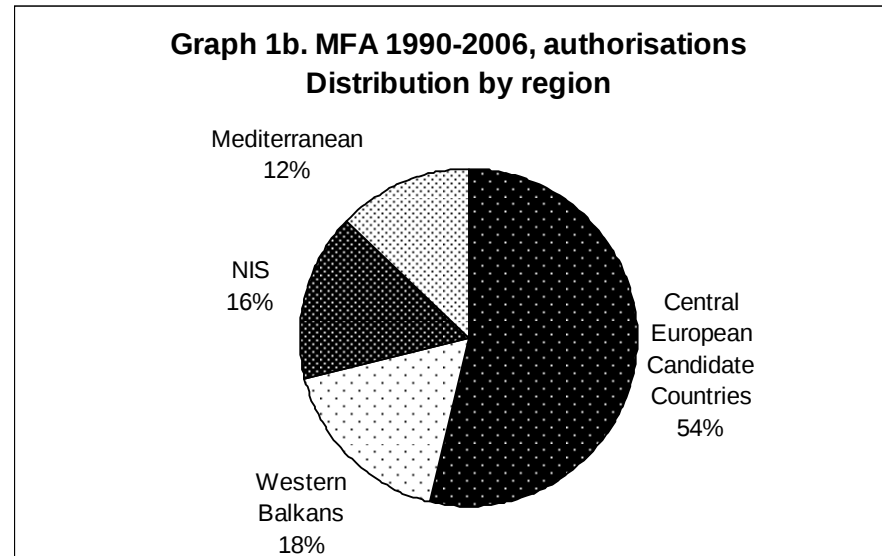
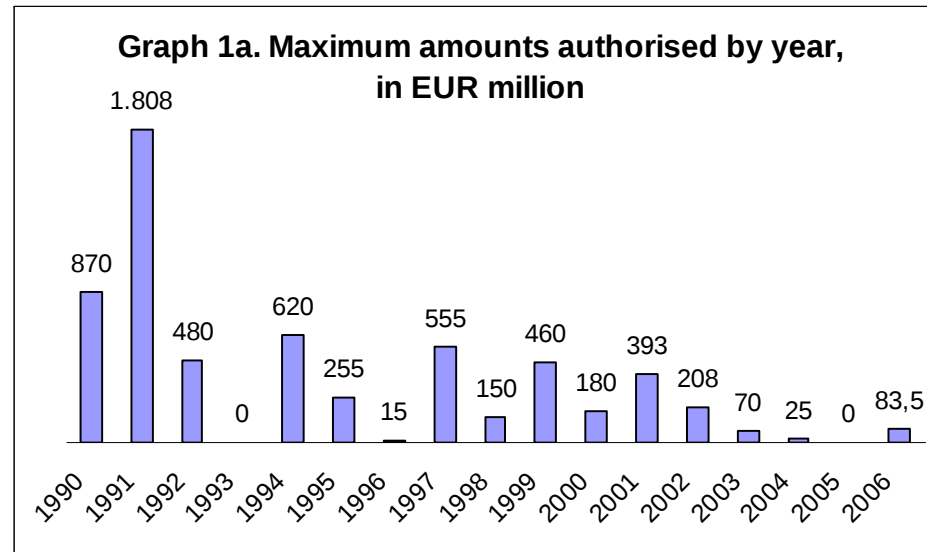
such as the implementation of single treasury accounts or the adoption of written procedures within the different Ministries of Finance.

Table 1. Macro-financial assistance, 1990-2006
Maximum amounts authorised, millions euro

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Totals
By region																		
Central European Candidate Countries	870	1.220	410		255			250		300								3.305
Western Balkans			70		35			40		160	55	393	190	70	25		50	1.088
NIS					130	255	15	265	150		125		18 (a)				33,5	991,5
Mediterranean		588			200													788
Total amounts authorised	870	1.808	480	0	620	255	15	555	150	460	180	393	208	70	25	0	83,5	6.172,5
out of which, straight grants		28	70		35			95		70	90	168	130	45	16		83,5	830,5
								Armenia and Georgia (95)		Bosnia (40) fYRoM (30)	Kosovo (35) Montenegro (20) Tajikistan (120) Moldova (15)	fYRoM (18) Serbia and Montenegro (75) Bosnia (40) Kosovo (30)	Serbia and Montenegro (45)	Serbia and Montenegro (45)	Albania (16)		Kosovo (50) Georgia (33,5)	
		Interest subsidies to Israel	Albania		Albania													

(a) net amount taking into account (b) and, for Ukraine, new loan of EUR 110 million together with simultaneous cancellation of EUR 92 million out of the EUR 150 million loan decided in 1998.

(b) grant of EUR 15 million and simultaneous cancellation of the EUR 15 million loan decided in 2000



**Graph 1c. MFA 2000-2006, authorisations
Distribution by region**

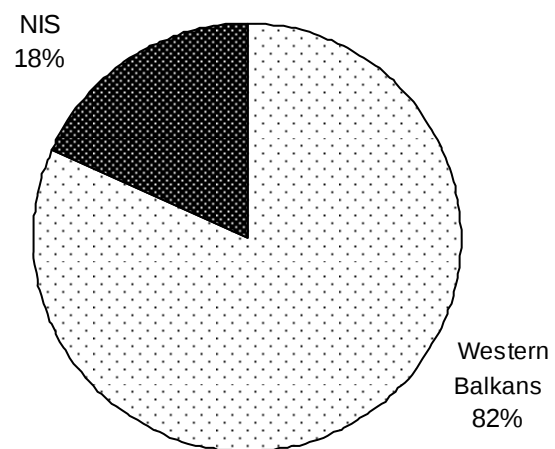


Table 2: Macro-financial assistance, 1990-2006

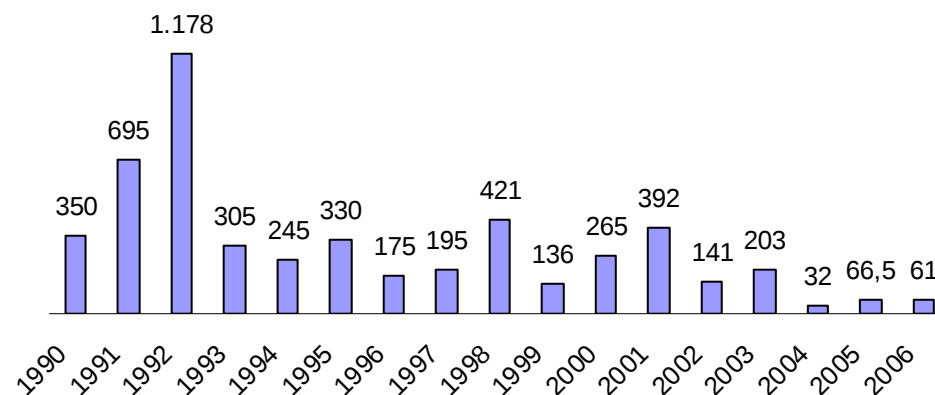
Disbursements, millions euro																		
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Totals
By region																		
Central European Candidate Countries	350	695	705	270	70	80	40	70	250	40	160			50				2.780
Western Balkans			35	35		15	20	25	15	25	105	312	130	146	20	58	32	973
NIS					25	135	115	100	156	71		80	11	7	12	8,5	29	750
Mediterranean			438		150	100												688
Total amounts disbursed	350	695	1.178	305	245	330	175	195	421	136	265	392	141	203	32	66,5	61	5.190,0
out of which, straight grants			63	35		15	20		18	28	85	105	141	85	22	51,5	42	710,5
													Armenia (11) Bosnia (15) Kosovo (15) Serbia and Montenegro (115)	Bosnia (25, Serbia and Montenegro (35), fYRoM (18), Tajikistan (7)	Serbia and Montenegro (10) Armenia (5,5) Georgia(6,5)	Serbia and Montenegro (25) Bosnia(15) Albania(3) Armenia (1,5) Tajikistan (7)	Albania (13) Tajikistan (7) Georgia (22)	

NB: 2000 figures include disbursements in favour of Bosnia, fYRoM and Montenegro which, for technical reasons, took place in early January 2001.

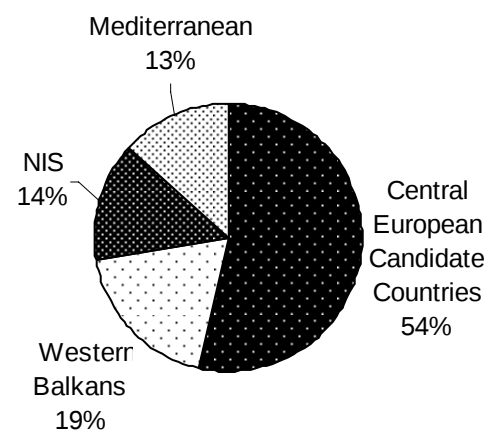
2001 figures include disbursements in favour of fYRoM and Tajikistan which, for technical reasons, took place in early January 2002.

2002 figures include disbursements in favour of Bosnia and Tajikistan which, for technical reasons, took place in early 2003.

**Graph 2a. Amounts disbursed by year,
in EUR million**



**Graph 2b. MFA 1990-2006, disbursements,
Distribution by region**



**Graph 2c. MFA 2000-2006, disbursements,
Distribution by region**

